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No. 08-1134

In the Supreme Court of the United States

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UNITED STUDENT AID FUNDS, INC.,
Petitioner,

v.

FRANCISCO J. ESPINOSA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

Brief of the States of Oregon, Alabama, Alaska, Arizona, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Iowa, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, Ohio, Oklahoma, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, Wyoming, and the National League of Cities

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QUESTIONS PRESENTED

Section 523(a)(8) of the Bankruptcy Code provides that student loans are nondischargeable unless the debtor affirmatively shows that repayment of the loan would impose an undue hardship. In turn, Rule 7001(6) of the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rule") provides that the determination of dischargeability of a debt must be established in an adversary proceeding (a separate proceeding within a bankruptcy case that is litigated directly between the debtor and the other party). Finally, Bankruptcy Rule 7004 provides that an adversary proceeding, like a standard civil proceeding in federal court, is initiated by service of a summons and complaint on the defendant party. The questions presented are:

1. If a debtor ignores the requirements of Bankruptcy Rules 7001(6) and 7004 and purports to discharge a student debt through a Chapter 13 plan, rather than by an adversary proceeding, has the debtor satisfied the due process requirements of *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306 (1950) – that a party must provide "notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections?"

2. If a debtor fails to satisfy those due process

requirements, is the plan confirmation order void with respect to the purported discharge or are its terms binding, under principles of *res judicata*, on a party that does not object to the proposed plan?

3. Does the bankruptcy court have authority to disapprove a plan that provides for actions that the Bankruptcy Rules state must be taken by adversary proceeding?

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STATEMENT OF AMICI INTEREST[1]

The Amici States frequently appear as creditors in bankruptcy cases and are often charged with collecting student loans, which are not discharged in bankruptcy unless a debtor successfully prosecutes an adversary proceeding. They hold other claims that are automatically excepted from discharge in Chapter 13;[2] the logic of the Ninth Circuit's analysis would also make those debts susceptible to discharge without the adversary proceedings required by the Bankruptcy Code and Rules.[3] Among those debts are claims arising from late or non-filed tax returns or taxes

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[1] The parties to the case received timely notice and have consented to the filing of this brief and the joinder of the National League of Cities ("NLC") to this brief; the consents have been filed with the Clerk of the Court. No counsel for a party authored this brief, and no person, other than the amici curiae, their members, or their counsel, made any monetary contribution to the preparation or submission of this brief. For purposes of this brief, NLC is included within the term "Amici States."

[2] Chapter 13 of the Bankruptcy Code, 11 U.S.C. 1301 et seq. Citations herein will be to the provisions of the Bankruptcy Code, 11 U.S.C. 101 et. seq., ("the Code") unless noted otherwise.

[3] All citations to a "Rule" or "Bankruptcy Rule" are to the Federal Rules of Bankruptcy Procedure.

a debtor sought to fraudulently evade, fraud, unscheduled debts, domestic support obligations, drunk driving judgments, and criminal sentences – many of which were recently added by Congress when it expanded the scope of discharge exceptions in Chapter 13 in 2005 in the Bankruptcy Abuse Prevention and Consumer Protection Act (the "BAPCPA").[4] The Amici States have a substantial interest in ensuring that debtors' plans are not allowed to circumvent Congress's clear intent.

Taken together, the Bankruptcy Code and Rules provide that the bankruptcy court's authority to determine whether a particular debt fits into an exception from discharge must be exercised through an adversary proceeding – a separate action directed at and naming a single creditor. The proceeding must be initiated by a complaint that is served with a summons on an officer or other agent authorized to receive service of process for the creditor. That method of proceeding is distinct from that required to confirm a plan and provides notice of the proposed discharge with far greater force and clarity to a person who can reasonably be expected to understand the significance of that notice. Under the Ninth Circuit's analysis, however, those debts could be discharged by the mere inclusion of a

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[4] Pub. L. No. 109-8.

sentence in a Chapter 13 plan, sidestepping protections that creditors otherwise have.

The Ninth Circuit's analysis condones actions that contravene fundamental provisions of the Bankruptcy Code and Rules, creates a chaotic process in Chapter 13[5] that lays traps for the unwary, requires prudent parties (especially already financially stressed state agencies, schools, colleges, and universities) to incur unnecessary costs, and burdens courts and Chapter 13 trustees with reviewing plans multiple times – once when a plan with an improper provision is filed and again after a vigilant creditor demands its removal. The debtor's approach here – often referred to as "discharge by declaration" or "discharge by ambush" – is antithetical to his obligation to deal equitably with his creditors when seeking the benefit of a discharge and violates

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[5] The discussion herein primarily focuses on Chapter 13 because the vast majority of plans filed by individuals (for which the discharge exceptions are applicable) occur in Chapter 13 cases (as opposed to Chapters 11 and 12). Further, as discussed below, the financial stakes in the former cases are so much smaller that creditors cannot afford the same degree of scrutiny of hundreds of thousands of plans in such cases, compared to the relatively minute number of cases in the other chapters. The Rules, though, apply across the board in all chapters.

due process.[6]

The Amici States also appear in Chapter 13 cases to protect their secured claims and are concerned that debtors will use Chapter 13 plans to invalidate security interests, even though Bankruptcy Rule 7001(2) provides that actions to "determine the extent, priority, and validity" of liens must also be brought by adversary proceedings. The Amici States seek to ensure that their priority claims and liens – for taxes, for costs of environmental cleanups, and for a myriad of other purposes –are not lost in future ambushes by debtors.

The practical impact of the decision below is that creditors must *presume* that debtors will include unlawful provisions in their plans and omit legally-required notices. Even if large institutional creditors, such as petitioner, can adapt to this abusive tactic, the result will be increased collection costs that must be passed on to all bor-

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[6] While the Amici States, as governmental entities, are not entitled to due process under the Fifth Amendment, they still must receive notice which satisfies the requirement of fundamental fairness. *See United States v. Hairopoulos (In re Hairopoulos)*, 118 F.3d 1240, 1244 n. 3 (8th Cir.1997); *United States v. Cardinal Mine Supply*, 916 F.2d 1087, 1089 n. 3 (6th Cir.1990). Discharge by declaration violates that requirement.

rowers. This is particularly harmful in the student loan area because the costs of collection are not allocated to the specific debtors who force such costs to be incurred, but rather are imposed *pro rata* on all other student debtors.[7] Similarly, the taxpayers of the Amici States will be forced to assume the added burdens of forcing debtors to play by the rules of the bankruptcy system they have chosen to invoke. Finally, the Amici States' citizens who hold nondischargeable judgments may find that the debtor has eliminated their rights through the simple expedient of a plan provision.

The added costs imposed by the decision below will be increased even further by virtue of the Ninth Circuit's final ruling in the case – namely, that bankruptcy courts may not act *sua sponte* to bar confirmation of abusive plans or to police the actions of debtors and their counsel. The original outbreak of "discharge by ambush" cases ended in large part because bankruptcy courts, acting under their own authority, warned practitioners of their disapproval and of the possibility that such

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[7] *See Black v. Educational Credit Mgmt. Corp.*, 459 F.3d 796, 800-01 (7th Cir. 2006) (upholding imposition of collection costs as uniform percentage of debt owed).

provisions could lead to sanctions.[8] By barring such review, the Ninth Circuit's holding immunizes practitioners and suggests that a debtor's attorney should always take the chance of seeing if such a provision will go unnoticed. In an era of unprecedented budget shortfalls, the Amici States are deeply concerned that they not be forced to shoulder unnecessary costs to protect themselves from debtors who refuse to abide by the Code and Rules.

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[8] *See, e.g., In re Mammel*, 221 B.R. 238, 243 (Bankr. N.D. Iowa 1998) (denying confirmation of plan with discharge provision, and describing practice as "trap for unwary creditors" that "trivializes the entire process and reduces it to a game of chance"); *In re Evans*, 242 B.R. 407, 411-13 (Bankr. S.D. Ohio 1999) (ordering debtor's counsel to show cause why provision did not violate Bankruptcy Rule 9011); *In re Hensley*, 249 B.R. 318, 323-24 (Bankr. W.D. Okla. 2000) (deeming counsel's intentional inclusion of discharge language unethical and sanctionable)); *In re Lemons*, 285 B.R. 327, 333 (Bankr. W.D. Okla. 2002) (imposing sanctions for use of discharge language and admonishing counsel); and *In re Wright*, 279 B.R. 886, 889 (Bankr. D. Kan. 2002) (noting that absent good-faith basis, inclusion of discharge provision in hope of trapping unwary student loan creditor should result in sanctions). *Cf. Taylor v. Freeland & Kronz*, 503 U.S. 638, 644 (1992) (explaining that while frivolous exemptions were binding if not objected to, result would not immunize debtor's counsel from sanctions).

STATEMENT OF CASE

In 1988-89, Espinosa obtained various student loans. In 1992, he filed a Chapter 13 case that listed his student loans as his only debts, proposed to pay only the principal, and stated that any unpaid amounts would be discharged. He did not file an adversary proceeding nor did his plan assert that payment of the interest would be an "undue hardship."[9]

Further, instead of serving an officer, managing or general agent, or other agent authorized to receive service of process with a summons and complaint as required by Bankruptcy Rule 7004(a) and (b)(3), Espinosa only mailed a copy of his plan to a post office box where payments on his loans were sent. The guarantor (the petitioner herein) did not object to the plan. After it was confirmed and Espinosa completed his payments, a standard discharge order was entered in 1997, providing that student loan debts were excepted from discharge. Espinosa did not object to the entry of that order or seek to have it corrected. In 2000, the Education Department began collection efforts and caused Espinosa's income tax refunds

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[9] Compare *Andersen v. UNIPAC-NEBHELP (In re Andersen),* 179 F.3d 1253 (10th Cir. 1999) in which the debtor asserted that payment of additional amounts beyond that set out in the plan would constitute an "undue hardship."

to be intercepted. Three years later, he filed a motion alleging that those actions violated the discharge injunction. The guarantor moved, under Federal Rule of Civil Procedure 60(b)(4), for relief from the confirmation order (which had approved the plan with the discharge language). The bankruptcy court ruled for Espinosa, though, finding that the confirmation order's terms controlled over the contrary language in the discharge order.

The district court reversed, holding that the confirmation order was void for lack of due process because of the absence of an adversary proceeding. On further appeal, after the bankruptcy court corrected the discharge order as a clerical error, pursuant to Bankruptcy Rule 9024 (the counterpart to Federal Rule of Civil Procedure 60(a)), the Ninth Circuit reversed the district court and entered the order at issue here, upholding the bankruptcy court's ruling that *res judicata* barred any attack on the plan's terms. *In re Espinosa*, 553 F.3d 1193 (9th Cir. 2008). The guarantor's petition followed.

ARGUMENT

The Ninth Circuit's analysis reduces to a few basic – but fallacious – propositions. First, despite Bankruptcy Rule 7001(6), which requires an adversary proceeding and proof of undue hardship to discharge a student loan debt, a debtor's

plan may simply provide that the debt will be discharged. Second, despite the requirement in Bankruptcy Rule 7004 that an adversary proceeding must be brought by means of a complaint and summons served upon specified parties at a specified address, the debtor may mail a copy of the plan to a different, generic address and not name those parties. Third, the creditor cannot assume that legal requirements for notice will be complied with, and fourth, violation of the Rules has no relevance to whether due process has been accorded to litigants pursuant to *Mullane*. Rather, due process merely requires some generic degree of notice, even if that form of notice *violates* a rule or statute and even if a creditor could be misled by the absence of the required notice.

At the outset, it is important to clarify that the Amici States fully understand this Court's decisions concerning the general finality of confirmation orders. In particular, they are mindful of this Court's recent holding in *Travelers Indemnity Co. v. Bailey,* 129 S.Ct. 2195 (2009), that principles of *res judicata*, in general, protect plan provisions from collateral attack. However, as this Court noted, *res judicata* does not protect an order that was entered in violation of due process. *Id.* at 2207. It is that lack of due process that distinguishes this situation from that in *Travelers* and similar cases.

Five other circuits have correctly reasoned

that the use of a plan provision to create a "discharge by declaration" violates due process. It is not simply that the provision in the Espinosa plan substantively violated the Bankruptcy Code (although it plainly did); it is also the fact that the discharge of a nondischargeable debt was obtained by means of plan confirmation, even though the Bankruptcy Rules undeniably mandate a different and more demanding process with heightened notice. It is the combination of those violations that sets the dividing line between the issues the Amici States concede are governed by *res judicata* and those that are not. If a matter may lawfully be decided in the plan confirmation process, the fact that a proposed provision violates the Code is not necessarily enough to eliminate the application of *res judicata*. But, if the Code and the Rules make clear that the proper procedure is an adversary proceeding, the right of the creditor to wait until it is sued in that manner before deciding whether or not to defend the action against it, cannot, consistent with due process and fundamental fairness, be extinguished by some other method of proceeding.

I. The Use of a Plan Provision to "Discharge" this Debt Violates the Code and the Rules

The Amici States adopt the discussion in the petitioner's brief of the structure under the

Bankruptcy Code and Rules for processing a claim that a particular debt should be discharged. They describe briefly this structure solely to show how widely the process used in this case missed the mark.

Section 523 specifies the debts that are excepted from discharge and the procedural requirements for dealing with those exceptions. Some types of debts are non-dischargeable only if the creditor timely brings an adversary proceeding to except the debt from the general discharge granted the debtor.[10] All other discharge exceptions, though, including the student loan exception set out at 11 U.S.C. § 523(a)(8), are self-executing and the creditor need do nothing.

If the debtor seeks to determine whether a particular debt fits within a discharge exception, he may file an adversary proceeding with the bankruptcy court or he can wait to be sued by the creditor and assert the discharge as a defense. In either case, the determination plays out in a formal litigation setting, between the only two parties that have any stake in it – the debtor and the creditor holding the claim.

Because discharge determinations are likely to be a critical issue for most creditors, the Bank-

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[10] Those exceptions are set out at 11 U.S.C. §§ 523(a)(2), (4), and (6).

ruptcy Code and Rules impose notice requirements that distinguish them from the vast mass of other paper work that flows through the bankruptcy system. Those special requirements give proper deference to the fact that Congress has specifically determined that certain debts should either not be discharged at all or should be discharged only if the debtor satisfies a stringent standard. Finally, as a practical matter, addressing discharge exceptions in an adversary proceeding ensures that the plan confirmation process is not burdened by one-creditor issues that do not affect other creditors or what the debtor must pay under the plan.

This Court recognized those principles in *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440, 449-452 (2004), in which it described Section 523(a)(8) as "self-executing;" stated that the debtor must "affirmatively secure[] a hardship determination" to discharge a student loan debt; added that creditors are given "greater procedural protection" before such debts can be discharged; and held that an adversary proceeding must be filed to discharge the debt. This Court did, to be sure, state that "*absent Rule 7001(6)*, a debtor could proceed by motion . . . which would raise no constitutional concern," 541 U.S. at 453 (emphasis added), but Rule 7001(6) *does* exist and it *does* impose affirmative obligations on a debtor. The suggestion that *Hood* allows courts to

disregard Rule 7001(6) was rightfully rejected by *In re Hanson*, 397 F.3d 482, 487 (7th Cir. 2005). *Hood* states that Congress has discretion to decide when to give parties more than minimal due process; it certainly does not authorize courts to arbitrarily disregard the choice that Congress *has* made.

In any event, Espinosa's position is that the confirmation order is valid even if its entry violated the Code or the Rules, because some minimal form of notice *was* provided. Under that analysis, no due process violation could ever occur even if a creditor is misled by the debtor's failure to comply with the prescribed notice requirements. Indeed, according to the Ninth Circuit it would be "wrong and dangerous" to allow Congress to define what due process requires. *Espinosa*, 553 F.3d at 1204.

The Amici States assert, to the contrary, that, while Congress cannot approve a procedure that falls below the Constitutional minimum for due process, it certainly may determine in certain cases that due process requires that parties receive more than that constitutional minimum. And, Congress having done so, those parties are entitled to rely on that grant of rights and act accordingly. Denying those rights violates due process under *Mullane* because one of the "circumstances" that must be considered is the collection of rights parties have been informed that they

possess and can rely on having. That is true in any civil proceeding; it is critical in the unique scenario posed by bankruptcy proceedings.

II. Bankruptcy's Unique Nature Demands a Consistent Application of the Rules.

Bankruptcy is quantitatively different from any other federal litigation and that fact explains the many differences in the way cases are handled. Bankruptcy filings are far more numerous than all other federal cases combined – and the ratio between the two has increased dramatically during the last twenty years. In 1988, when Espinosa took out his loans, there were 549,612 nonbusiness bankruptcies. By 1992, when he filed his petition, that number had soared to 900,874, and by 1997, when he received a discharge, the number had grown by another 50 percent to 1,350,118. From 1998 to 2004, the number varied between a low of 1,217,972 in 2000 and a high of 1,625,208 in 2003.[11]

While it was frequently suggested that enactment of the BAPCPA would lead to a reduction in

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[11] All filing rates taken from charts maintained by American Bankruptcy Institute: http://www.abiworld.org/AM/AM Template.cfm ?Section= Home&TEMPLATE=/CM/Content Display.cfm& CONTENTID =56822. All websites were viewed on April 7, 2009, unless otherwise stated.

case filings, and while that did initially occur after its enactment in 2005, filings have increased every year since then. [12] For 2009, they are likely to return to the roughly 1.4-1.5 million average that predated the BAPCPA. As of the second quarter of 2009, filings totaled 1.3 million for the prior twelve months, but the June 2009 quarter alone had 381,000 filings. On an annualized basis, the June rate translates into 1.524 million filings.[13]

By contrast, in 1988, there were 43,670 federal criminal and 240,232 federal civil cases filed, or about 1 for every 2 bankruptcy filings.[14] In 1993, there were 46,786 federal criminal and 229,850

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[12] 620,000 petitions were filed in October 2005 to beat the BAPCPA's effective date, resulting in a total of more than two million cases in 2005. *See* http://www.abiworld.org /AM/Template.cfm? Section= Home& TEMPLATE=/CM/ContentDisplay.cfm &CONTENTID=42631. Case filings dropped to 600,000 in 2006, then rose to 800,000 in 2007 and to more than one million in 2008.

[13] *See* http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilings Jun2009.cfm, issued by Administrative Office of the U.S. Courts, viewed on August 19, 2009.

[14] Federal Judicial Workload Statistics, Tables C, D, F-2, issued by Administrative Office of the U.S. Courts, December, 1988.

federal civil cases filed, for a total of 276,636 cases,[15] still less than one for every three of the almost 900,000 bankruptcy filings. By 1997, though, other federal filings had risen only to 322,390, compared to 1.37 million bankruptcy filings – now a 1 to 4.2 ratio. Nonbankruptcy filings have varied little in recent years, averaging about 340,000 cases a year from 2004 to 2008,[16] as compared to bankruptcy filings which have returned to the 1.5 million range and the 1 to 4.2 ratio.

The reality is that bankruptcy, at least for consumer debtors, is a high volume, highly standardized practice in which lawyers and the courts use software packages, form pleadings, standard plans, "no look" fee approvals, and the like to handle the wholesale business of processing hundreds of thousands of petitions each year. Unlike a typical two-party dispute in civil or criminal litigation, bankruptcy almost inevitably involves unrelated claims by many different parties against the debtor. Those claims may arise under

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[15] *See* http://www.uscourts.gov/judicial business/judbus.pdf p. 12, issued by Administrative Office of the U.S. Courts, viewed on August 28, 2009. (Statistics are for FY 93, beginning October 1992).

[16] *See* http://www.uscourts.gov/judbus2008/contents.cfm for statistics for 2004-2008, Tables S-7 and D-2, viewed on August 19, 2009.

state law, federal nonbankruptcy law, or the Code, and the debtor (or trustee) must decide whether to accept or dispute them, in addition to contesting liens, defending challenges to exemptions, and administering property of the estate. Further, in Chapter 11, 12, and 13 cases, debtors have broad leeway to propose plan terms, and creditors may vote on or object to those proposed plans. Finally, the debtor and his creditors may litigate either his right to a general discharge or request that specific debts be discharged.

In this high-volume arena, creditors need to be able to rely on the rules. That need increases geometrically when a single defendant, such as a student loan creditor – or a taxing authority of the Amici States – is faced with literally thousands or tens of thousands of cases a year.[17] To cope with those filings in an economically realistic fashion, creditors must set up automated systems, delegate work to paralegals, and train secretarial staff as to which matters must be brought to counsel's attention and which do not

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[17] As noted by the petitioner, the federal student loan programs service more than $500 billion of loans. The petitioner states it received notice of 24,411 bankruptcies in 2008 alone. U.S. DEPT. OF EDUC., FINANCIAL AND PERFORMANCE QUARTERLY UPDATE, Issue 2008-2, at 7 (Sept. 30, 2008).

require further action.

This cacophony of actions would produce chaos absent the carefully-orchestrated provisions of the Code and the Rules which create detailed procedural mechanisms with specific notice, timing, and objection provisions for each type of action. There are 86 Federal Rules of Civil Procedure for district court litigation. By contrast, those rules are largely subsumed in only *one* chapter of the Bankruptcy Rules. There are an additional *eight* chapters of bankruptcy rules, spelling out how the case is to proceed. Virtually every bankruptcy court also has detailed local rules to further help guide, channel, and control the thousands of cases they handle each year.

That multitude of proceedings, moreover, takes place on a highly compressed schedule compared to normal federal litigation, especially in Chapter 13.[18] Moreover, the Bankruptcy Code

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[18] Chapter 13 plans must be filed no later than 15 days after the petition date. Bankruptcy Rule 3015(a). The confirmation hearing must be at least 20 days after the Section 341 meeting of creditors, which in turn, under Bankruptcy Rule 2003(a) and Section 1324(b), is to be held between 20 and 50 days after the case is filed. Thus, the plan confirmation hearing could be as early as the 40th day of the case and only 25 days after the plan is filed. Before 2005, no minimum period existed between the petition date and the confirmation hearing.

and the Rules are far more stringent in many respects about challenges to decisions than the rules that govern other federal litigation. Section 363(m), for instance, precludes a sale to a good faith purchaser from being overturned unless a stay has been obtained. Notices of appeal must be filed within 10 days rather than 30 (compare Bankruptcy Rule 8002(a) to Federal Rule of Appellate Procedure 4(a)(1)). Confirmation orders in Chapter 13 can only be overturned for fraud and only for six months.[19]

And, in yet another example of the stringent application of the Rules in bankruptcy, even a frivolous claim of exemption can be enforced unless the trustee challenges the claim within the required deadline. *See Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992). The Court is currently scheduled to hear a case this term, *Schwab v. Reilly*, No. 08-538, 129 S.Ct. 2049 (2009), in which the Third Circuit held that a trustee had to challenge not only facially invalid exemptions, but also those that implicitly could be read to assert an improper claim. Failing to do so, the Third Circuit held, barred the trustee from later contesting the debtor's ability to claim the improper amounts that it had impliedly exempted. In short, in light of the severe consequences the Bankruptcy Code and Rules visit upon parties

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[19] §1330(a).

that fail to take a required step, it becomes even more critical for notice requirements to be followed and consistently enforced.

That is particularly true when a third significant reality of Chapter 13 cases is considered, namely, that despite the large amount of litigation that may arise in any given case, these are, on average, very low-dollar proceedings. In fiscal year 2008, for instance, payments made through Chapter 13 cases totaled some $5.2 billion, of which only $1.2 billion dollars went to pay the claims of *all* unsecured creditors.[20] Divided by the roughly 353,000 Chapter 13 cases filed in 2008,[21] that resulted in an average payout to *all* unsecured creditors of only $3400 per case. When potential recoveries are so small, unsecured creditors like student loan guarantors generally can expect little from the plan itself. Rather, their primary hope of return is for their debt not to be discharged so they can resume collection activities after competing obligations are discharged.

A creditor with a nondischargeable claim will

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[20] *See* http://www.usdoj.gov/ust/eo/private_trustee/library/chapter13; Chart ch13ar08AARpt.xls – FY-2008 Chapter 13 Trustee Audited Annual Reports. Viewed on August 19, 2009.

[21] *See* http://www.uscourts.gov/Press_Releases/2008/BankruptcyFilings Dec2008.cfm.

have little reason to fear the plan's treatment of its claim, if the plan cannot discharge the debt. Rather, the debtor has every incentive to pay as much as possible on the nondischargeable debt during the case and, indeed, to give such debts preferential treatment to reduce the amount he will need to pay after the bankruptcy. Courts differ on whether such treatment is allowed;[22] the salient point is that, if the plan cannot discharge the debt, the debtor has no reason to underpay that creditor. The creditor, in turn then, can direct its limited resources to defending *bona fide* challenges brought via adversary proceedings.

On the other hand, if debtors may ignore both substantive and procedural requirements, they have every reason to seek approval of plans that discharge debts improperly. If, as the Ninth Circuit ruled, such plans are absolutely protected if the creditor does not object, and if bankruptcy courts are precluded from policing them *sua sponte*, then debtors, at least initially, will be successful in gaining unwarranted benefits. While large creditors with many cases presumably will learn to adapt their actions to this new regimen (*albeit* at substantial, unnecessary cost and burden to all parties), occasional creditors

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[22] *See* discussion of contrasting lines of cases in *Marshall v. Belda (In re Belda)*, 315 B.R. 477, 482-86 (N.D. Ill. 2004).

may not learn until too late that they were foolish to have assumed that the Rules applied to debtors too.

III. Failure to Provide a Party with the Notice Required by the Rules Denies That Party Due Process

The Ninth Circuit's ruling puts it squarely in conflict with five other circuits[23] – a fact that it readily conceded. Moreover, it was forced to overrule both the district court in this case and the Ninth Circuit Bankruptcy Appellate Panel ("BAP") in *In re Repp,* 307 B.R. 144 (9th Cir. BAP 2004), *reversed by Espinosa,* 553 F.3d at 1204, n. 6. In each of those cases, the creditor did not object to the plan or appeal from confirmation, but sought to collect the debt after the plan ended, only to be met by the contention that the con-

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[23] *Whelton v. Educ. Credit Mgmt. Corp.*, 432 F.3d 150, 154-55, 156, n.2 (2nd Cir. 2005) (using plan process makes discharge provision "void *ab initio*"); *Banks v. Sallie Mae Servicing Corp.*, 299 F.3d 296, 300 (4th Cir. 2002); *In re Ruehle*, 412 F.3d 679, 682-83 (6th Cir. 2004); *In re Hanson*, 397 F.3d 482, 486 (7th Cir. 2005); *Educ. Credit. Mgmt. Corp. v. Mersmann (In re Mersmann)*, 505 F.3d 1033 (10th Cir., 2007) ("§ 1325(a)(1) . . . permits the confirmation of a plan *only* if it is consistent with the rest of the Code"; "bankruptcy court lacks authority to confirm" plan that does not use adversary proceeding).

firmed plan was *res judicata*. In each case, the Court of Appeals held that *res judicata* did not apply because the orders were void because the debtor had violated due process requirements by failing to initiate an adversary proceeding or to provide proper notice. Because of those violations, it was impossible to satisfy one of the conditions for the application of *res judicata*, namely that the defendant had received a full and adequate opportunity to litigate the issues. Compare the Tenth Circuit's decisions in *Andersen v. UNIPAC-NEBHELP* (*In re Anderson*), 179 F.3d 1253 (10th Cir. 1999), which utilized the *res judicata* approach, with its *en banc* decision in *Mersmann*, 505 F.3d at 1049, where it reversed its earlier position once the due process argument was presented.

The same analysis has also been applied to the use of plans to purportedly invalidate liens in circumstances where Bankruptcy Rule 7001(2) requires an adversary proceeding. Three circuits have held that doing so violates due process and have invalidated provisions in plans that attempted to avoid liens. *See In re Mansaray-Ruffin*, 530 F.3d 230, 235-36 (3rd Cir. 2008); *In re Bateman*, 331 F.3d 821, 830-833 (11th Cir. 2003); *Cen-Pen Corp. v. Hanson*, 58 F.3d 89 (4th Cir. 1995). Indeed, in both *In re Brawders*, 503 F.3d 856, 869-870 (9th Cir. 2007) (affirming decision by BAP), and *In re Enewally*, 368 F.3d 1165, 1173

(9th Cir. 2004), the Ninth Circuit had, until the decision below, been consistent with its sister circuits, confirming that due process requires that matters that must be raised in an adversary proceeding cannot be determined by a plan. The decision in this case has left that court at odds not only with the other circuits, but even itself.[24]

The distinction between using an adversary proceeding versus plan language to discharge a debt is not merely semantics. Plan language is a short and simple statement of the debtor's intentions; it requires neither explanation nor justification. That is particularly true in Chapter 13 cases in which plans are often form documents, prepared in a "fill in the blanks" format, comprising only a few pages. Moreover, the debtor need not even serve the full Chapter 13 plan on creditors, but is permitted to provide a mere summary. *See* Bankruptcy Rule 3015(d), Section 521(e)(3) (full plan must be provided to a creditor *only* if it requests the plan and pays for the copy it receives).

Adversary proceedings, by contrast, are com-

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[24] The decision below purported to distinguish the language in *Enewally* as being mere dicta – but the Bankruptcy Appellate Panel's decision in *Brawders*, which was affirmed by the Ninth Circuit, was clearly based on a reading of *Enewally* consistent with the petitioner's view here.

menced by filing a complaint that must, under Bankruptcy Rules 7004 and 7008, show "that the [debtor] is entitled to relief" and describe the specific relief sought. Thus, unlike a debtor's bare assertion in a plan that a student loan debt should be discharged, a complaint must assert facts that demonstrate undue hardship. *Bell Atlantic v. Twombly*, 550 U.S. 544 (2006) and *Ashcroft v. Iqbal*, 129 S.Ct. 1937 (2009). Moreover, the complaint must name the specific party in interest and be served with a summons on a high-level official or person designated to receive service. The combination of the formal structure of a complaint, coupled with heightened notice provisions, ensures that a responsible person at the creditor will be alerted in a clear and direct fashion that the creditor's *specific* interests are being challenged and that it must take heed of those interests or suffer a default. That process is surely more likely to ensure that the creditor will respond to the challenge than merely sending a copy of the plan to a post office drop box.

Congress has every right to protect creditors with nondischargeable debts by granting them that added level of notice. It is not difficult to understand why Congress would have made that choice in light of the practical realities of bankruptcy cited above. Large creditors, like USA Funds, receive "tidal waves of mail. . . . The quantity 'of notice' that is issued by the bank-

ruptcy system is so overwhelming that it is necessary to have clear rules in order for creditors to know what notices to notice as opposed to the notices that are deafening legal background noise. The Code and the Rules set forth those clear standards and it is up to the courts to ensure that the lines are not blurred." *In re Ruehle*, 412 F.3d 679, 684 (6th Cir. 2004).

As this Court stated in *Mullane*, due process requires "notice reasonably calculated, *under all the circumstances*, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." *Mullane* 339 U.S. at 314 (emphasis added). The other Circuits have concluded that, at a minimum, those "circumstances" include the fact that parties have been promised a specific level and form of proceeding and of notice. *See, e.g., Banks*, 299 F.3d at 302 ("due process generally entitles a party to receive the notice specified before an order binding the party will be afforded preclusive effect"); *Ruehle*, 412 F.3d at 684-85 (parties are "entitled to the prescribed level of notice for the process to be due"); *Mersmann*, 505 F.3d at 1049 ("creditor has a right to assume that he will receive all of the notices *required by statute* before his claim is forever barred")(emphasis by *Mersmann* court).

This Court took the same view in *City of New York v. New York, New Haven & Hartford R.R.*, 344 U.S. 293 (1953), where it considered whether

a party could be bound by a confirmation order when it knew of the case but had not been mailed notice of the hearing on the plan as required by the Bankruptcy Act and rules. This Court rejected the argument that knowledge of the case would put a party on inquiry notice so that it would be obligated to take steps to learn of the hearing, stating that "even creditors who have knowledge of a reorganization have a right to assume that the *statutory* 'reasonable notice' will be given them before their claims are forever barred." (Emphasis added).[25]

The same is true here – the creditors have been told that any attempt to discharge their debt will take place in an adversary proceeding and that they will receive a particular form of "reasonable notice" of the commencement of that proceeding. The debtor, though, brought a differ-

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[25] Under other circumstances (*i.e.*, in Chapter 7 and 13 cases where the Rules are far more specific about the timing and sequence of bar dates in the case), parties may be required to inquire. *See In re Metzger*, 346 B.R. 806, 817-19 (Bankr. N.D. Cal. 2006), explaining the differences and noting the effect of varying statutory provisions in the different chapters. Thus, it is clear that there is no one single-size notice that satisfies all constitutional duties; plainly, though, the decision by Congress to specify a particular form of notice and proceeding is entitled to deference.

ent form of action and provided a different, lesser, form of notice, but argues that the alternatives were "good enough." The Ninth Circuit agreed, holding that mailing a plan to a post office box would have been minimally adequate notice in a constitutional sense, in the absence of any specified provisions in the statute or Rule. It was immaterial to the Ninth Circuit's due process analysis, therefore, that what was done was not the form of service and proceeding that was *required* by an existing Rule for this particular circumstance.

That conclusion, though, ignores the critical distinction between being told nothing about what is required, and being promised that matters would proceed in a particular way. If nothing had been said in the Code or Rules about how undue hardship would be decided, the creditor would have no alternative but to examine each paper it received with care to determine if a discharge action was lurking within. But, because the Code and Rules specify a particular form of proceeding and notice, creditors have a right to rely on those specifications and to adjust their monitoring efforts accordingly. They should not have to assume that the party providing notice will ignore the Rules and the Code and substitute its own procedures.

Indeed, as noted by the Ninth Circuit Bankruptcy Appellate Panel in *Brawders* (in a decision

affirmed by the Ninth Circuit), it had previously held that "the greater the deviation from the process set out in the rules, 'the greater the quality and amount of notice needed in order to comply with due process.'" *Brawders*, 503 F.3d at 870-71 (BAP decision *citing GMAC Mortgage Corp. v. Salisbury (In re Loloee)*, 241 B.R. 655, 662 (9th Cir. BAP 1999)). It further noted that it had held, in *Varela v. Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)*, 293 B.R. 489, 497 (9th Cir. BAP 2003), that to include a claims objection in a Chapter 11 plan,

> considerations of due process mandate great caution and require that the creditor receive specific notice (not buried in a disclosure statement or plan provision) of at least the quality of specificity, and be afforded the same opportunity to litigate one-on-one, as would be provided with a straightforward claim objection under Rule 3007.[26]

In short, the more one decides to ignore the re-

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[26] Indeed, Bankruptcy Rule 3007 was amended, as of December 1, 2007, to limit the number and types of objections in a single pleading and to bar inclusion of adversary matters in a claims objection. Thus, it is clear that the Rules drafters and Congress have recently opted to require more notice to creditors, not less, in contrast to the Ninth Circuit.

quirements established by the Code and the Rules, the more likely it is that parties will be misled in a way that is fundamentally unfair and that violates the due process rights of those who justifiably relied on those provisions.

The decision below brushes aside these considerations and suggests that a party risks waiving its rights when it does not respond to *any* form of information that it receives that might implicate its claims. That is simply not the case, though. A party that receives by regular mail a civil complaint, without personal service, has no duty to respond, despite his full knowledge of its contents. It is only when proper personal service is obtained under Federal Rule of Civil Procedure 4 that the defendant has an obligation to defend the suit. [27]

The Bankruptcy Rules provide for service of a complaint by mail in Rule 7004(b) in addition to personal service, but Rule 7004(b)(3) nonetheless requires service on an "officer, managing or general agent, or [] any other agent authorized by appointment or by law to receiver service of process." Mailing a plan notice to a lockbox does not

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[27] Of course, a plaintiff could include a request to waive service under Fed. R. Civ. Proc. 4(d)(1). To actually waive the right to formal service, though, a proper party must sign the waiver, thus ensuring the equivalent of personal service.

satisfy that obligation, much less the requirement that the document at issue must be an adversary complaint. Even assuming the plan document here ever came to the attention of a responsible official of petitioner (an assumption for which the Ninth Circuit cites no evidentiary support), the fact remains that a party receiving a plan with a provision that cannot lawfully be decided in that context is not required to object thereto.

That principle is part of the bedrock of jurisdiction in and outside of bankruptcy; there is nothing about the discharge or Chapter 13 plan process that dictates a different result. *See, e.g., Hamlett v. Amsouth Bank (In re Hamlett)*, 322 F.3d 342, 345-46 (4th Cir. 2003) (default judgment vacated because service made on registered agent of depository institution, not "officer," as required in Rule 7004(h)); *In the Matter of McMahon (Miller v. Homecomings Fin. Network, Inc.*, 2008 Bankr. LEXIS 3635, *9-10 (Bankr. N.D. Ind. 11/18/08) (failure to address summons to attention of corporate officer, as opposed to merely corporation, as required by Rule 7003(b)(3), made service defective and allowed for lifting of default judgment); *In re E-Z Serve Convenience Stores, Inc. et al.(CIT Group/Business Credit, Inc., vs. Official Committee of Unsecured Creditors of E-Z Serve Convenience Stores, Inc., et. al)*, 318 B.R. 631, 635-36 (Bankr. M.D.N.C.

2004) (reconsidering order avoiding creditor's lien because relief sought by motion rather than adversary proceeding).

Espinosa's position here stands that principle on its head by asserting that he is not bound by the Rules; rather, he may devise whatever forms of proceeding and service he chooses and, if the court believes those efforts are minimally likely to bring the matter at issue to the creditor's attention, the creditor is bound. That cannot be the law because it leaves every other party in the case unsure of what it must do to protect its rights, particularly in the high-volume, low-payment reality of Chapter 13 cases.

If the Rules had said, "no action can be taken to discharge a debt unless the notice is sent in a blue envelope," a creditor could reasonably judge that it need not read mail in white envelopes if it is only concerned with discharge actions. The result should be no different here. The Ninth Circuit considered the violation of the Rules to be wholly irrelevant, stating that the guarantor was sophisticated and that it was "highly unlikely" that it was misled by "customary bankruptcy procedure," *Espinosa,* 553 F.3d at 1205. That would be true, though, only if is "customary" for debtors to ignore the Code and the Rules. Indeed, it is more likely that a "sophisticated creditor" – that is, one conversant with the pertinent statute and rules – would be misled because of its reliance

thereon. A bankruptcy novice with only a single case might not read the Rules and – unlike larger creditors – might have time to read every single piece of paper with which it was served.

A comparison of the facts in *Mullane* to those here shows how far the Ninth Circuit's method of analysis strays from that required by this Court. In *Mullane*, a trustee sought to settle his accounts in a situation where thousands of parties were involved, there was no reason to assume he had done anything wrong, and he could not ascertain names and addresses for many of those parties. He sought to proceed under a state law that explicitly *allowed* publication notice to *all* parties in such circumstances. Even though this was the only action involving those beneficiaries, and even though they might be thought responsible for learning the state law and gauging their monitoring accordingly, this Court held that publication notice was not sufficient. It could be used for unknown creditors, because no better method was available, but known creditors were entitled to actual service. Due process, this Court held, is not a mere gesture, but is measured by the steps a person takes who truly wants to communicate with another.

The Ninth Circuit's holding below, by contrast, applies even when a debtor *violates* the Rules and the Code, the plan takes away the creditor's rights, the debtor can expect opposition from the

creditor, there is a manageable number of creditors to notify, and the debtor can readily obtain information to effectuate proper service. In the world of Chapter 13, debtors know that creditors managing large case loads will rely on the Rules and the Code to determine the level of their monitoring efforts. Allowing debtors to exploit that reliance by violating the Rules and the Code does not satisfy *Mullane's* requirements; it is the antithesis of *Mullane*. *Mullane* does not dictate a "one size fits all" form of notice for due process purposes; it requires a consideration of "all of the circumstances." The fact that, in *some* circumstances, due process may not require that the party receive actual notice at all (for example, when publication notice is the only possible means to attempt service), surely does not dictate the Ninth Circuit's opposite conclusion that any form of actual notice will automatically satisfy due process. In its amendatory opinion, reported at 553 F.3d 1193, the Ninth Circuit held that it was "bizarre" to assume that the Constitution might require anything more than actual notice.

In fact, what is bizarre is the court's implicit conclusion that parties should be penalized for relying on notice requirements mandated by Congress.[28]

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[28] Indeed, the Ninth Circuit in its original opinion had overruled the BAP's decision in *Brawders*, which

It is clear, as the other five circuits have held, that adherence to the principles enunciated in *Mullane* and *City of New York* means that a debtor may not obtain a binding order discharging a debt unless the debtor complies with the requirements Congress has established for obtaining that order. Failing to follow those procedures means that the creditor has been denied due process and that the confirmation order is void with respect to that provision. Accordingly, the actions of petitioner here did not violate the discharge injunction.

By contrast, the Ninth Circuit's opinion reinvigorates the concept of discharge by ambush. It creates uncertainty and leaves parties to grapple with an amorphous balancing process despite the fact that Congress has prescribed the proper process with complete clarity. Under the Rules, the result is simple – either a summons and complaint are prepared and served on a proper party, or they are not. But under the Ninth Circuit's approach, courts must decide whether some other,

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explicitly held that greater degrees of notice had to be given if a party violated the Rules. In the revised opinion, though, it reversed its position and left *Brawders* intact, thus retaining a decision whose holding directly contradicted this statement. Thus, again, the Ninth Circuit's holdings contradict each other as well as those of other circuits.

lesser form of process is adequate under the circumstances of each particular case. The Ninth Circuit's approach imposes added costs and burdens on an already overcrowded bankruptcy system and provides no countervailing benefits. Those difficulties will increase in light of the new exceptions to the Chapter 13 discharge, which will give debtors even greater incentives to evade the Rules than before the passage of the BAPCPA. It is critical that this Court reverse this holding before it spurs another round of abuse.

IV. A Creditor's Failure to Object to a Plan Provision Does Not Bar the Bankruptcy Court From Acting *Sua Sponte* to Review the Plan

Perhaps the most troubling aspects of the opinion are the Ninth Circuit's twin assertions: first, that a creditor's failure to file an objection suggests its affirmative consent to the discharge of the debt owed to it, and second, that such purported "consent" made it improper for the bankruptcy court to raise a *sua sponte* challenge to the plan's terms.

First, there is no apparent evidentiary basis for the Ninth Circuit's suggestion that the guarantor here, or a creditor in general, that does not object to a plan in which its claim is purportedly discharged actually *agrees* to that discharge. Because a creditor may both receive partial pay-

ment under a plan and have the balance excepted from discharge, it is unclear why it would ever agree to accept the payment and allow the discharge. But, assuming a creditor was willing for its debt to be discharged, it can always state that consent affirmatively to the debtor, or it can default on its response to the adversary complaint when filed. The assumption that silence, in the face of unlawful provisions, implies actual consent will only increase the procedural free-for-all occasioned by this ruling.

The other aspect of the ruling – that bankruptcy courts are *not allowed* to challenge illegal provisions *sua sponte* – ignores the broad policing powers granted to bankruptcy courts by Section 105(a). That section states:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

Courts have relied on that authority to enforce Rule 7001 and the substantive provisions of the Code that determine how student loans may be

discharged. The Ninth Circuit now holds that they may not independently do so. It erred in so holding.

Section 1322(b)(11) provides that a Chapter 13 plan may contain any provision "not inconsistent with this title." Section 1325(a)(1) provides that the court "shall confirm a plan if . . . (1) the plan complies with the provisions of this chapter and with the other applicable provisions of this title." And, finally, Section 1325(a)(3) states that the court shall confirm a plan if ". . . (3) the plan has been proposed in good faith and not by any means forbidden by law." Thus, Congress has thrice stated that plans must only contain lawful provisions and that courts are to confirm *lawful* plans. A plan that discharges a student loan debt with no showing of hardship violates Section 523(a)(8) and Section 1328(a)(2).

Numerous circuits have concluded that the provisions of Section 1325 are binding obligations that the debtors must follow – and that courts are to enforce in deciding whether to confirm a plan. *See, e.g.*, the extensive discussion in *Shaw v. Aurgroup Financial Credit Union*, 552 F.3d 447, 452-58 (6th Cir. 2009) (citing, *inter alia,* three decisions of this Court referring to Section 1325 as requirements a plan *must* satisfy to be confirmed) and *Mersmann*, 505 F.3d at 1048, 1049 ("§ 1325(a)(1) . . . permits the confirmation of a plan *only* if it is consistent with the rest of the Code";

"bankruptcy court lacks authority to confirm" plan that does not use adversary proceeding). The Third Circuit in *In re Szostek*, 886 F.2d 1405 (3d Cir. 1989), did use broad language suggesting in dicta that those provisions were not mandatory. Notably, the Ninth Circuit, in *In re Barnes*, 32 F.3d 405, 407 (9th Cir. 1994), was among the circuits that *rejected* the Third Circuit's approach and deemed the requirements of Section 1325(a) mandatory. Moreover, even the Third Circuit has held, in *Mansaray-Ruffin*, 530 F.3d at 237-38, that general *res judicata* provisions do not allow a debtor to avoid a lien through a plan provision where the Rules require an adversary proceeding – a situation precisely analogous to the discharge provision at issue here.

It is plainly inconsistent then for the Ninth Circuit to hold that a bankruptcy court is *forbidden* from enforcing the provisions of Section 1325 under its own authority, as Section 105(a) allows. If, in fact, the debtor can prove undue hardship and the creditor does not dispute the debtor's right to a discharge, the parties can easily stipulate to that effect to resolve the matter if the issue is raised by the bankruptcy court. (Notably, there is no evidence that the debtor here has ever indicated a willingness or ability to make such a showing.) If a debtor cannot satisfy the Code's requirements, the bankruptcy system is far better served by allowing bankruptcy courts to police

their dockets and cut off these abusive tactics at an early stage, rather than requiring them to preside over the duplicative, wasteful, and expensive system the Ninth Circuit's opinion envisions.

V. Debtors Seeking the Equitable Remedy of a Discharge Must Act Equitably Towards Their Creditors

It has often been held that bankruptcy courts are essentially courts of equity. *See, e.g., Katchen v. Landy*, 382 U.S. 323, 327 (1966). It is an established maxim that those who seek equity must behave equitably in turn to those dealing with them. When debtors seek the enormous equitable benefit of a discharge, it is not too much to ask that they afford their creditors the notice rights that Congress has required. Bankruptcy should not be a game of "gotcha," of debtors violating the Rules and attempting to slip provisions past creditors that are following the Rules. Instead, it should be a process by which each party obtains what it is due – nothing more and nothing less.

As noted above, this Court is also considering the case of *Schwab v. Reilly*. In that case, the debtor similarly argues that it managed to slip an unlawful provision past the other parties and is, therefore, entitled to retain a benefit to which it was plainly not entitled. Regardless of how the Court rules on whether the trustee should have understood that the debtor was asserting an

unlawful exemption, it is clear that accepting the debtor's position will require trustees to file objections that would be wholly unnecessary if debtors did not seek to obtain more than the law allows. By the same token, the debtor's approach and that of the Ninth Circuit in this case will also impose added costs and burdens for all parties (including the debtors) to no useful purpose. This Court should ensure that this large and complex system that provides great benefit and relief to those honest but unfortunate citizens suffering from financial stress should not be undermined by the actions of those who seek more than that which they have been granted.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision below.

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